Supreme Court, U.S.
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No. 86-1006

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1986

MARATHON OIL COMPANY, an Ohio corporation,
Petitioner,
vs.
UNITED STATES OF AMERICA; UNITED STATES DEPARTMENT OF THE INTERIOR; DONALD HODEL, Secretary of the Interior; ESTHER WUNNICKE, Commissioner of the Department of Natural Resources, State of Alaska; COOK INLET REGION, INC., an Alaska corporation,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF OF RESPONDENT COOK INLET REGION, INC. IN OPPOSITION

MUNGER, TOLLES & OLSON
WILLIAM D. TEMKO,
Counsel of Record
355 South Grand Avenue
Los Angeles, California 90071
(213) 683-9100

Attorneys for Respondent Cook Inlet Region, Inc.

Bowne of Los Angeles, Inc., Law Printers. (213) BOWNE CO

QUESTION PRESENTED

Respondent Cook Inlet Region, Inc. objects to the Petitioner's statement of the Questions Presented. The Petitioner has misstated the basis for the Court of Appeals' decision, and, in so doing, has mischaracterized the questions raised in this case. The only question presented herein is as follows: Whether, under the deferential standard of review prescribed in the Administrative Procedure Act, 5 U.S.C. § 706(2)(A), (E), the administrative royalty orders issued to the Petitioner by the Secretary of the Interior were authorized by the applicable statutes, regulations and lease terms, all of which confer upon the Secretary broad discretionary authority to establish the royalty value of gas produced from Federal leases.

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MARATHON OIL COMPANY, an Ohio corporation,
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UNITED STATES OF AMERICA; UNITED STATES DEPARTMENT OF THE INTERIOR; DONALD HODEL, Secretary of the Interior; ESTHER WUNNICKE, Commissioner of the Department of Natural Resources, State of Alaska; COOK INLET REGION, INC., an Alaska corporation,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF OF RESPONDENT COOK INLET REGION, INC. IN OPPOSITION

Respondent Cook Inlet Region, Inc. ("CIRI") respectfully requests that this Court deny the Petition for a Writ of Certiorari to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit, which appears in the Appendix to the Petition at 2a-17a, was originally reported at 794 F.2d 1461, but then temporarily withdrawn from publication. On January 6, 1987, the Court of Appeals issued a further Order authorizing the opinion to be re-released for publication, but the re-published opinion has not yet appeared in West's bound volumes. The opinion of the United States District Court for the District of Alaska, reported at 604 F.Supp. 1375, appears in the Appendix to the Petition at 22a-53a.

JURISDICTION

The judgment and opinion of the United States Court of Appeals for the Ninth Circuit were entered on July 24, 1986. A petition for rehearing and suggestion for hearing *en banc* was denied by the Court of Appeals on January 22, 1987. Although the petition for rehearing was not timely filed, on October 3, 1986 Justice O'Connor extended the time for filing a petition for writ of certiorari to and including December 21, 1986. The petition herein was filed on December 19, 1986. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATEMENT OF THE CASE

A. Introduction

Petitioner Marathon Oil Company ("Marathon") owns a nearly fifty percent (50%) undivided working interest in seven Federal oil and gas leases within the Kenai Field in Alaska (the "Federal Leases"). Under the terms of those leases, Marathon is required to pay the lessors a royalty

equal to twelve and one half percent (12½%) of the value of any oil or gas produced and sold from the leased lands.

Because of conveyances of certain lands to Respondent CIRI pursuant to provisions of the Alaska Native Claims Settlement Act ("ANCSA"), 43 U.S.C. § 1601 *et seq.*, CIRI is entitled to approximately sixty-five percent (65%) of the royalties from oil and gas produced from the Federal Leases, with the remaining thirty-five percent (35%) going to the Federal Government.[1]

B. The Secretary Of The Interior's Statutory And Regulatory Authority To Establish The Royalty Value Of Federal Lease Production

Under the provisions of the Marathon leases, as well as the applicable Federal regulations incorporated by reference therein, the authority to determine the value of any oil or gas produced from the leases, for purposes of computing Marathon's royalty payment obligations to the

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[1]CIRI is one of the twelve Alaska Native Regional Corporations established by Congress under ANCSA. Pursuant to Section 7(i) of ANCSA, 43 U.S.C. § 1606(i), and the Section 7(i) Settlement Agreement dated June 29, 1982, which was approved by the United States District Court for the District of Alaska on June 3, 1983, *see Aleut Corp., et al. v. Arctic Slope Regional Corp., et al.*, Civil No. A75-53 (D. Alaska), seventy percent (70%) of CIRI's annual net revenues from the subsurface estate conveyed to it under ANCSA is subject to sharing among the twelve Native Regional Corporations. Thus, the other eleven Regional Corporations have a right to receive a percentage of the overall annual net revenue stream generated from subsurface resource development on lands conveyed to CIRI under ANCSA. Accordingly, any royalty payments which CIRI receives from Marathon on gas production from the Federal Leases is included in CIRI's gross subsurface revenues in calculating the amounts subject to sharing among the Alaska Native Community pursuant to Section 7(i) of ANCSA.

lessors, rests with the Secretary of the Interior ("Secretary").

The Mineral Lands Leasing Act, 30 U.S.C. §§ 181 *et seq., as amended*, was enacted by Congress in 1920 "to promote wise development of natural resources and to obtain for the public reasonable financial returns on assets belonging to the public." *Mountain States Legal Foundation v. Andrus*, 449 F.Supp. 383, 392 (D. Wyo. 1980). In Section 32 of the Act, 30 U.S.C. § 189, Congress authorized the Secretary "to prescribe necessary and proper rules and regulations and to do any and all things necessary to carry out and accomplish the purposes of [the Act]. . . ." It is pursuant to that statutory authority that the Secretary has issued regulations and orders regarding the calculation and payment of royalties on Federal Lease production. The courts have held that such regulations have the force and effect of statutes when not inconsistent with or repugnant to the statute in question. *See, e.g., California Company v. Seaton*, 189 F.Supp. 445, 449 (D.D.C. 1960), *aff'd sub nom. California Company v. Udall*, 295 F.2d 384 (D.C. Cir. 1961).

The Federal Leases themselves further reinforce the Secretary's broad authority to establish the royalty value of oil and gas produced from the lease premises. In the initial paragraph of each of the Federal Leases, Marathon agreed to lease the mineral lands in question "subject to the terms and provisions of the [Mineral Lands Leasing] Act, and all reasonable regulations of the Secretary of the Interior now or hereafter in force." Pursuant to Paragraph 2(d)(1) of the Leases, moreover, Marathon, as lessee, is obligated to pay the lessor "12-½ percent royalty on the production removed or sold from the leased lands *computed in accordance with the Oil and Gas Operating Regulations* (30 C.F.R. Part 221) [30 CFR § 206.103]."

Finally, under Paragraph 2(d)(2) of the Federal Leases, Marathon has "expressly agreed that the Secretary of the Interior may establish reasonable minimum values for purposes of computing royalty on . . . gas" removed or sold from the leased lands.

The Oil and Gas Operating Regulations, incorporated by reference in each of Marathon's Federal Leases, establish the applicable standard for determining the value of production for purposes of computing royalties under the Leases:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director [of the Minerals Management Service of the Department of the Interior]. . . . *Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof* or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price . . . paid or offered at the time of production in a fair and open market for the major portion of like-quality . . . gas . . . produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

30 C.F.R. § 206.103 (1986) (emphasis added) [formerly codified at 30 C.F.R. § 221.47]. It is clear, therefore, that the terms of the Federal Leases, and the regulations by which Marathon expressly agreed to be bound when it executed those Leases, reserve to the Secretary, through the Minerals Management Service ("MMS"), the author-

ity to establish the royalty value of the oil and gas produced from the leased lands.

C. Petitioner's Gas Sales In Japan

Marathon delivers a portion of the gas produced from its Kenai Field leases to its liquified natural gas ("LNG") facility at Nikiski, Alaska, where, through a multi-step cooling process, the temperature of the gas is lowered so as to transpose the gas from a vapor into a liquid. This temperature reduction process does not in any way alter the molecular composition of the gas. Once liquefied, the gas is transported by tanker to Japan, where it is sold by Marathon to two Japanese utilities. The point of first sale of Petitioner's Kenai Field gas shipped to Japan — *i.e.*, the first arm's-length sale following production of the gas — occurs when the gas is sold to those Japanese utilities in Yokohama, Japan.

D. The Royalty Orders Issued To Petitioner By The Department of The Interior

Since as long ago as 1977, the Department of the Interior ("DOI") has disputed the method by which Marathon has valued the gas sold in Japan for purposes of computing its royalty obligations and, over the years, has undertaken efforts to collect additional royalties from Marathon on that gas. For almost eight years, however, Marathon resisted those periodic Federal royalty collection efforts in order to avoid its royalty payment obligations under the Federal Leases. In this royalty enforcement action against Marathon, the Government has sought, once and for all, to put an end to Marathon's eight-year strategy of resistance and delay.

On July 8, 1983, pursuant to its authority to establish the value of production for royalty calculation purposes,

DOI issued an administrative order to Marathon, requiring it to begin paying royalties on the gas sold in Japan based upon the gross proceeds accruing to the company from the sale of the gas. That royalty order was based upon the explicit DOI royalty regulations which establish "gross proceeds" as the minimum royalty value for gas produced from Federal oil and gas leases.

Marathon exercised its right under the DOI regulations to appeal the July 8, 1983 royalty order. Despite that appeal, however, Marathon was obligated by statute, regulation, and the terms of its leases to comply with that royalty order pending any appeal therefrom. Notwithstanding that express obligation, however, Marathon failed and refused to comply with the explicit royalty payment directive set forth in the July 8, 1983 MMS order. In fact, effective April 1983, Marathon began paying royalties on its Japanese gas sales based on an even lower value than it had been utilizing before DOI notified it that it was to begin paying royalties based upon the gross proceeds methodology.

Over the course of the next eleven months, DOI issued two further orders to Marathon regarding its underpayment of royalties on the Federal lease production sold in Japan. However, despite these two additional chances to comply with the MMS directives, Marathon persisted in refusing to make the royalty payments demanded.

On April 14, 1983, even before MMS had issued the first royalty order to Marathon, Marathon filed a declaratory judgment action against the United States, the State of Alaska, and CIRI in Federal District Court in Alaska challenging DOI's authority to require it to calculate and pay royalties based on the gross proceeds methodology proposed by MMS. Marathon later amended that original complaint to challenge the validity of the July 8, 1983

royalty order, as well as the subsequent orders of October 5, 1983 and June 11, 1984. The United States counterclaimed, requesting a court order upholding the validity of the three MMS royalty orders, requiring Marathon to account for and pay all royalties due and owing under those directives, and cancelling Marathon's leases for nonpayment of royalties.

The parties agreed that the underlying issue in the case — the validity and enforceability of the MMS orders — was a question of law that could properly be decided by the Court on summary judgment. Accordingly, the parties submitted the case on cross-motions for summary judgment and a hearing on the parties' respective summary judgment motions was held in the District Court on January 4, 1985. On February 20, 1985, the District Court issued a thorough opinion, 604 F.Supp. 1375 (D. Alaska 1985), granting summary judgment for the Federal Government, upholding the validity of the three MMS royalty orders, and issuing a mandatory injunction in favor of the Federal Defendants[2] requiring Marathon to comply with the terms of the royalty orders and to conduct an accounting of the royalty amounts due and owing thereunder. *See* Appendix to the Petition at 22a-53a. In so ruling, the Court held that the MMS Orders issued to Marathon were within the agency's authority under the applicable statutes and regulations, and neither violated nor were inconsistent with the Federal Leases which, by their express terms, provided for a royalty to be paid on production removed or sold from lease lands computed in accordance with the applicable oil and gas operating regulations. *Id.*, at 43a-45a.

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[2]The Federal Defendants are collectively the United States of America, the United States Department of the Interior and Donald Hodel, Secretary of the Interior.

The Ninth Circuit, in an opinion written by Judge Wallace, affirmed. Appendix to Petition at 2a-17a. The Court of Appeals endorsed the reasoning of the District Court's thorough and careful opinion and upheld the District Court's determination regarding the validity of the netback royalty orders issued by MMS. *Id.,* at 10a-11a. The Court of Appeals also rejected various other arguments raised by Marathon that had not been explicitly addressed in the District Court's opinion. *Id.*, at 11a-17a.

REASONS FOR DENYING THE WRIT

The Petitioner has grossly mischaracterized the decision of the Court of Appeals. In point of fact, the decision of the Ninth Circuit is clearly correct and fully in accord with the precedent of this Court and of other circuits. Accordingly, the petition should be denied.

The MMS Royalty Orders Were Clearly Reasonable And Fully In Accord With The Mineral Lands Leasing Act And The Regulations And Leases Issued Pursuant Thereto

As the courts have long recognized, the Secretary of the Interior, through MMS, is vested with considerable discretion to determine the value of oil and gas for royalty calculation purposes and to establish the terms and conditions for the payment of such royalties. *See, e.g., Continental Oil Company v. United States,* 184 F.2d 802, 821 (9th Cir. 1950). As noted above, this authority is not only embodied in the relevant statutes and regulations, but is also incorporated directly into the Federal Leases. Thus, as the District Court properly observed below, "[b]oth the regulations and the leases . . . vest in the administrative agency the authority to establish the basis for computing royalties." Appendix to the Petition, at 36a.

MMS' determination that Marathon is required, under the "gross proceeds" language of the regulation, to value the gas at issue based upon its sales price for the gas in Japan (less allowances for transportation and liquefaction costs, as well as a return on investment) is a "reasonable" interpretation of the DOI royalty value regulation. Petitioner cannot demonstrate that DOI's interpretation of the "gross proceeds" language in its own regulations is "clearly erroneous." *See, e.g., United States v. Larionoff,* 431 U.S. 864, 872 (1977). Nor is there any suggestion in the record in this case that DOI officials engaged in fraud, dishonesty, or bad faith in issuing the royalty orders to Marathon. *See Continental Oil Company v. United States, supra.* To the contrary, the record indicates that there was clearly a "rational basis" for MMS's decision to issue the gross proceeds royalty orders to Marathon and that MMS did not "entirely [fail] to consider [any] important aspect of the problem" or offer an explanation for its decision that ran "counter to the evidence before the agency." *See, e.g., Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co.,* 463 U.S. 29, 43 (1983). Accordingly, the royalty value determinations at issue in this action were properly sustained by both the District Court and the Court of Appeals.

In short, the decisions of both the Court of Appeals and the District Court to uphold the administrative royalty orders issued by the Secretary in this case can hardly be said to involve the application of novel principles of law. Rather, to the contrary, both Judge Wallace's opinion in the Ninth Circuit and the District Court opinion upon which it relies simply apply longstanding and well-established legal principles governing the judicial review of administrative agency action under the Administrative Procedure Act.

In a desperate attempt to somehow bring this case within the provisions of Rule 17 of this Court, Petitioner contends that, in upholding the royalty orders issued by DOI, Judge Wallace improperly deferred to the Secretary's interpretation of the statutory term "royalty" in the Mineral Lands Leasing Act. In so arguing, however, Petitioner grossly mischaracterizes the decision of the Ninth Circuit below.

Petitioner does not dispute the fact that, under the terms of its Federal Leases, it is obligated to pay the United States a 12½ percent (12½%) royalty "computed in accordance with the Oil and Gas Operating Regulations (30 CFR Part 221) . . .," and that, under those Leases, the Secretary is given explicit authority to "establish reasonable minimum values" for purposes of computing that royalty. Nor does Petitioner dispute the fact that the applicable DOI royalty valuation regulations, incorporated by reference in each of its Leases, expressly provide, in part, that "[*u*]*nder no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof.* . . ." 30 C.F.R. § 206.103 (emphasis added).

As noted, above, the courts have held that such regulations have the force and effect of statutes when not inconsistent with or repugnant to the enabling statute in question. *See, e.g., Chevron U.S.A. Inc. v. Natural Resources Defense Counsel, Inc.,* 467 U.S. 837 (1984) ("Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute."); *Chapman v. Sheridan-Wyoming Coal Co.,* 338 U.S. 621, 629 (1950) (A regulation promulgated pursuant to the Mineral Leasing Act has the force of law.). *See also California Company v. Seaton, supra.*

The regulation is unambiguous. It is the Associate Director of MMS who must determine the value of production for purposes of computing royalty, and the value so determined may not be less than the gross proceeds received by the lessee. The gross proceeds accruing to Petitioner from its Japanese gas sales (less allowances for costs of transportation and liquefaction, as well as a return on investment) constitute the *minimum* value of that gas for purposes of computing Marathon's royalty obligation to the United States. *See Kerr-McGee Oil Industries, Inc.*, 70 I.D. 464, 470 (1963) ("In making their negotiations of their sales contracts the appellants were or should have been aware of this regulation expressly providing that *the value basis must be at least as much as the gross proceeds which the lessee would obtain from the sale of the gas. . . .*") (emphasis added). *Accord*: Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases No. 5 (NTL-5), Section II.A.2 and II.B. (May 1, 1977).

The three MMS royalty orders to Marathon, prepared by DOI only after lengthy analysis and deliberation of the issues within the Department, were issued for one fundamental purpose — to ensure that, in compliance with that explicit and unambiguous regulatory mandate, Marathon was valuing the gas sold in Japan, for royalty purposes, *at no less than its "gross proceeds."* Thus, under those Orders, DOI directed Marathon to begin calculating the value of its LNG for royalty purposes by deducting actual cooling and transportation expenses from the price which it receives for the gas in Japan. This is the "gross proceeds" referred to in the regulations. That term is

commonly understood in the industry. According to Professor Hemingway:

> Royalty payable upon the "proceeds" of the sale of gas, will be computed on the basis of aggregate gross receipts from all products, less the costs of marketing and transportation.

R. Hemingway, *The Law of Oil and Gas*, 7.4 at 316 (1971, 1979 Supp.). Both the courts and the treatise writers have defined "proceeds" in accordance with this commonly accepted dictionary meaning, that is, the amount accruing to the lessee from the sale of its gas. *See* W. Williams and C. Meyers, *Manual of Oil and Gas Terms* at 5 (5th Ed. 1981); *Hoover & Bracken Energies, Inc.*, 52 IBLA 27, 88 I.D. 7 (1981), *aff'd*, 723 F.2d 1488 (10th Cir. 1983), *cert. denied*, 469 U.S. 821 (1984) (Gross proceeds described as "the amount the producer receives from the purchaser of the gas."); *Supron Energy Corp.*, 48 IBLA 181 (1980) ("Under 30 C.F.R. § 221.47, the value of production for royalty purposes must be at least *equal* to the actual proceeds accruing to the lessee upon sale of the output of the lease.") (emphasis in original); *Amoco Production Co.*, 29 IBLA 234, 236 (1977) ("Proceeds of a sale, unless there is something in the context showing to the contrary, means total proceeds."). *See also Wheless Drilling Company*, 80 I.D. 599, 13 IBLA 21 (1973).

Petitioner's protestations to the contrary notwithstanding, the fact remains that the principal legal issue in this case — whether the royalty orders are consistent with the applicable statutes and regulations — is precisely the type of question on which the courts must defer to the administrative agency. Thus, the agency's interpretation of the applicable statutes is entitled to substantial deference, particularly if the statute in question is one which the agency is charged with administering. *Chevron, U.S.A.*

Inc. v. Natural Resources Defense Counsel, Inc., supra, 467 U.S. at 837, 104 S.Ct. 2782-83; *Blum v. Bacon,* 457 U.S. 132, 141-42 (1982).

Such judicial deference to agency determinations is even more appropriate where, as in this case, interpretation of the agency's own administrative regulation is principally at issue. *Udall v. Tallman,* 380 U.S. 1, 16-17 (1965). As this Court stated in *United States v. Larionoff, supra,* 431 U.S. at 872, "an agency's interpretation of its own regulations is controlling, except where such an interpretation is clearly erroneous." *Accord: Bowles v. Seminole Rock & Sand Co.,* 325 U.S. 410, 414 (1945). This deference to the agency is particularly compelling, moreover, in the area of royalty valuation, where the Secretary is given broad discretion in exercising his regulatory authority to determine, for royalty purposes, the reasonable unit value of production under a specific lease. *Amoco Production Co.,* 29 IBLA 234 (1977). *See also Continental Oil Co. v. United States, supra,* 184 F.2d at 821 (Secretary's royalty value determinations must be sustained in the absence of fraud, dishonesty, or bad faith).

Petitioner seeks to avoid this overwhelming body of case law authority by suggesting that this case involves complicated questions of statutory intent. The fact remains that the key issue in this case is simply this — whether the royalty orders issued by the Secretary were authorized (indeed, if not mandated) by the "gross proceeds" language of the Oil and Gas Operating Regulations.

Petitioner evidently recognizes that the only way it can overcome the presumptive validity of the MMS orders is by arguing that the "gross proceeds" provision in the regulation is simply inapplicable in determining the royalty value of the gas sold in Japan. Thus, Petitioner

suggests that the "gross proceeds" methodology of royalty valuation is inapplicable where, as in the case at bar, the gas to be valued is sold off the lease premises. However, as the courts below recognized, there is nothing at all unusual about using a netback method to establish gross proceeds. As one court has noted, "[t]he work-back valuation is well recognized in the production and early processing of natural gas. It is commonly used . . . in placing a value on feed stock for gasoline plants and related processing." *Ashland Oil, Inc. v. Phillips Petroleum Co.*, 554 F.2d 381 (10th Cir. 1977) (en banc). Nor is Petitioner correct in its assertion that a netback method is the least preferred method of computing a royalty payment. Regardless of what other methods may be available to compute royalties, if a lease values royalties by reference to "gross proceeds," those proceeds must be computed on the bases of aggregate gross receipts from the product, less allowable costs. *See* R. Hemingway, *The Law of Oil and Gas*, 7.4 at 316 (1971 supp.). Indeed, the fundamental flaw in Petitioner's analysis is its failure to recognize that no matter what the prices of the gas under other contracts in the field may be, if Petitioner's gross proceeds from its own sale of the gas exceed those prices, then Petitioner must pay royalties on the basis of those proceeds. In other words, the netback method is not used as a proxy for determining the market value of the gas but is used to assure that royalties paid on the gas are not based on values that are less than what is actually received by the lessee.

CONCLUSION

The legal principles applied by Judge Wallace in the decison of the Ninth Circuit comport with the precedent of this Court, and do not conflict with the law of other

circuits. Accordingly, for the reasons stated above, Respondent CIRI respectfully requests this Court to deny the Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

DATED: February 23, 1987

Respectfully submitted,
MUNGER, TOLLES & OLSON

By: WILLIAM D. TEMKO
Counsel of Record
355 South Grand Avenue
Los Angeles, California 90071
(212) 683-9100

Attorneys for Respondent
Cook Inlet Region, Inc.

PROOF OF SERVICE BY MAIL

I am a citizen of the United States and a resident of the City and County of Los Angeles; I am over the age of eighteen years and not a party to the within action; my business address is: 1706 Maple Avenue, Los Angeles, California.

On February 23, 1987, I served the within Brief of Respondents in Opposition in re: "Marathon Oil Company vs. United States of America" in the United States Supreme Court, October Term 1986, No. 86-1006;

on the Parties in said action, by placing three copies thereof enclosed in a sealed envelope with postage fully prepaid, in the United States post office mail box at Los Angeles, California, addressed as follows:

Hon. Charles Fried
Solicitor General
Department of Justice
Washington, D.C. 20530

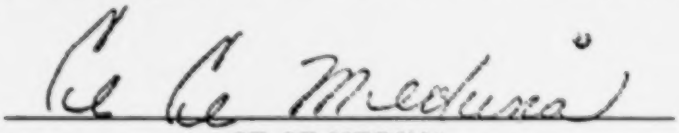
Charles J. Meyers
Gibson, Dunn & Crutcher
1801 California Street, 42nd Floor
Denver, Colorado 80202

Mark P. Worcester
Assistant Attorney General
State of Alaska
1031 West Fourth Avenue, Suite 200
Anchorage, Alaska 99501

All Parties required to be served have been served.

I certify (or declare), under penalty of perjury, that the foregoing is true and correct.

Executed on February 23, 1987, at Los Angeles, California



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